

# The implication of creative accounting on the firms



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This project will explore several definitions of creative accounting and the range of reasons for a company's directors to engage in creative accounting.

It explores the nature and occurrence of creative accounting practices within the context of ethical considerations.

In addition, it considers the various ways in which creative accounting can be found and summarizes some empirical research on the nature and incidence of creative accounting.

The role of the auditors in detection creative accounting is discussed, drawing evidence from several empirical studies.

Then, it will illustrate the source of data, the sampling method and the data analysis technique that had been chosen for this research.

Finally, the paper concludes with the analysis of possible solutions for the creative accounting problems.

## Chapter 1

### Introduction

Manipulation of financial information is known by several terms. In USA the preferred term and widely used is " Earnings management" whereas in Europe the favored term is " Creative Accounting" and also this term will be used in this study. The term can be defined in different ways. However, primarily it is ' a process whereby accountants use their knowledge of accounting rules to manipulate the figures reported in the accounts of a business'. Further definition will be explored later in this paper.

Creative accounting occurs when managers involve in changing the accounting figures to alter financial reporting. The motive behind the alteration is either to mislead stakeholders about the poor performance of a company or attract new contract and investment that depend on figures in statements.

This research will apply the previous study in some scandal cases, such as Enron to find out whether it has same motive as mentioned by other authors. In addition, it will show the way in which managers have used creative accounting to committed fraud.

The rest of study is organized as follows. In chapter 2 the literature is reviewed to pinpoint certain definition of creative accounting and explore the motives behind creative accounting. In chapter 3 the research method is employed to identify the relevance of creative accounting to Enron annual reports. In chapter 4 the paper will discuss major finding, recommendation and conclusion of the study. In chapter 5 different sources of the study will be listed including articles, journals and so on.

Rationale of study:

Many fraudulent cases had been found in the past few years. These scandals had been made by directors and managers of the organizations. There are numerous victims who suffered from misuse of the position starting from shareholders, going towards employees and end up with societies.

Although most of these organizations have been audited by external auditors, the fraud has been occurred within the firms. This is because the

auditors give only a reasonable assurance of their view on the financial statements and even some of them involved in fraud like Arthur Andersen.

There are many people who are still not aware of how the company may use creative accounting in manipulate the accounting figure and hence committed fraud.

This paper will explore the ethic and the way of using creative accounting providing with practical example.

Aims and Objectives:

To understand the meaning and explore definitions of creative accounting.

To explore several reasons or motives of the using CA by company's managers.

To list and explain the techniques of creative accounting.

To understand the role of auditors and responsibilities in deduction of CA.

To identify whether the auditors (both external and internal) play role in minimizing the CA in corporation.

To find out the implication of CA on the country's economy.

Limitations of Study

The research had successfully obtained the financial statements of Enron Corporation for four years started from 1997 till 2000. However, there was failure in collection the adjustment report's figure except for income and

long term debts. These missing figures might be important to use in methodology for accurate judgment. Furthermore, the time to accomplish this study was slightly short to collect some important data for this research.

## Chapter 2

### Literature Review

There are various scholars who defined creative accounting (CA) in different views. These are as follows.

‘ Involves the repetitive selection of accounting measurement or reporting rules in a particular pattern, the effect of which is to report a stream of income with a smaller variation from trend than would otherwise have appeared’. (Copeland, 1968)

‘ Is any action on the part of management which affects reported income and which provides no true economic advantage to the organization and may in fact, in the long-term, be detrimental’. (Merchant and Rockness, 1994)

‘ Whereby the true financial performance of a company is distorted by managers for private gains’ (Klein, 2002)

It has noticed that although scholars from different decades had defined the CA, they agree the basic concept of CA which is use knowledge of accounting rules to manipulate accounting figure to show the faulty result of the organization performance.

The reasons and motivations of creative accounting

Various authors have studied about the issue of management motivation towards creative accounting. There are many reasons. One of these was mentioned by:

Shafren (2009) concluded based on his analysis of Satyam Company that the stakeholders are interesting on company's financial statements because there are mean to show how the firm is performed and its position in market. Therefore, managers try depicting these figures in such way to send positive indicator to the investors. The investors always attracted if annual statement is superb. Thus, to express this view managers aim to modify the statement by means of tricks of CA. In other hand, the directors also have their own reasons as their bonuses may decide in proportion with the profit they made or reported. Lttner et al (1997) have also agreed that when the manger bonuses and stock options are depend on the company performance there is likely that the manager modify the figures upward to get the desired result.

other motivation was mentioned by Dharan and Lev (1993) who Showed in their study of ' The valuation consequence of accounting charges' that an organization used CA when its share price started to fall following the increase in share price which it reported previously. This reason arises when company face great pressure from a variety of obligations and constraints based on amounts reported in statements. For example: based on survey of US bank managers, they found that when a new bank manager hold responsible for an entity there is inspiration to adjust loan provision so he makes sure that any losses occurred by previous manager can be covered from this provision.

Whereas Beatty and Harris (2001) said that managers may manipulate the accounting figures in such way to reduce the burden of tax levies or to allow them to pay lowest possible income taxes by providing that the cost involved is less than the income tax benefit. Niskanen and Keloharju (2000) agreed in their research of 'earning cosmetics in a tax-driven accounting environment: evidence from Finnish public firms' which is based on European companies that the corporate tax could be the reason for CA used by managers of the company.

These are some of common motives for CA. However, the most noticeable motives are modifying the accounting figures to show positive indicator to investors and downward the firm income for tax purpose. Therefore, stakeholders should at least to be aware of these two areas. If there were more independent directors in the board then there will be less motivation or even it can be eliminated. Therefore, the best way in elimination this practice is not to know the ways that can be occurred but to appoint more independent directors.

#### Techniques of creative accounting

Largay (2002) wrote in his article of 'Lessons from Enron' regardless of the high regulation exist in some countries like USA, the accounting environment afford great flexibility. The potential way for CA and the techniques can be found in certain areas.

One of the techniques which can be used in CA as mentioned by Schipper (1989) is flexibility in regulation. He added in the article of 'Commentary on creative accounting' that accounting regulation provides a great flexibility in <https://assignbuster.com/the-implication-of-creative-accounting-on-the-firms/>

choosing any policies that are set by International Accounting Standard Board, for example it allows the non-current assets to be valued either at historical cost or at revalued amount. Thus, if management decide to change policies of the company it may easy to deduct in the year of change but it is much difficult to be identified after sometimes probably after few years.

Another point is the lake of regulation in some area existing in almost every country. AS it can be seen in Romania and Spain where there are few mandatory requirements for stock option and recognition of pension liabilities.

CA can also be finding as the discretionary position of the management that may used in some items to obtain

stability in financial position. This had explained by McNichols and Wilson (1988) that manager may decide to increase or decrease the provision of bad debts to adjust the desire result. The timing of some transactions also offers mangers the opportunity to increase the revenue and give an impression result when net profit is not adequate. For instance, company has an investment in historical cost which can be sold at current value (i. e. at higher value) where operating profit is showing an adverse figure. The third technique mentioned by the author is the artificial transactions that are usually use to manipulate balance sheet amount or to move the profit figure between accounting periods. This can be achieved by entering the related transactions with third party like a bank. Suppose an arrangement had made with bank to sell the asset to bank and lease back the same asset for the entire of its useful life. The arrangement consists of selling the asset at lower



or higher value than in an uncontrolled transaction and the compensation is from the difference of rental price.

The another technique had explained by Gramlich et al (2001) in which they said that firms may attempt to manipulate balance sheet in order to change the liabilities classification to improve liquidity ratio. Most of time this manipulation is occurred to improve the investors perception. Although there is not much difference between 298 million and 301 million, investors perceived the latest amount more than the earlier one.

The International Accounting Standard had been created to reduce or even eliminate the accounting fraud that is occurred by the management of the organization. However, sometimes IAS unintentionally play role in committing fraud by providing different ways of treatment of an item in financial statements. All of the techniques have one motive which is to makes FS more attractive on the view of stakeholders.

### The role of auditors and their responsibilities

After many alleged scandal cases occurred in last decade, many individuals, such as shareholders have lost confidence on the audit firms. They are wondering the responsibility of the auditors in deduction the fraud and whether they played key role in committing fraud.

According to Audit Committee Institute (2007) auditors should be aware of all circumstances that lead the firm to face a pressure from both within and outside the organization and thus, encouragement firm to involve in inappropriate earnings management (creative accounting). The independent

audit should be often alert of the possibility occurrence of CA and should deeply understanding the company's processes in modifying accounting policies, estimates and judgments in order to assess these processes.

Donaldson and Palmer (2003) were mentioned in conference the role that auditors played in accounting scandals of Enron and WorldCom. The auditors failed to resist pressure faced by the manager and therefore, accept the misleading financial statements i. e. they involved in fraud. Auditing may depend on external sources to verifying data. However, if the employees of the company have an intention to defeat the auditing function, they can cooperate with individuals outside the company, so even the best auditors will be unable to protect investors from such conduct at all cases.

The role of auditors in minimizing the CA in the firm

It had mentioned above how the auditors were involved in corporate scandal. However, internal and external auditors are also play role in at least to minimize these scandals when the audit standards, accounting standards and ethical code of conduct have been properly used.

Ebrahim (2001) had mentioned in his study of ' Auditing Quality, Auditor Tenure, Client Importance, and Earnings Management: An Additional Evidence' how the quality of auditors can be effective on earnings management or CA behavior. He used sample that listed in NASDAQ, NYSE and AMEX. The data was collected for 9 to 11 years. The sample included only the firms with fiscal year ended i. e. December 31. He found that the quality of auditor and the firm size had no relation with creative accounting.

Amat et al (2008) argued in their empirical study of 'Earnings management and audit adjustments: An empirical study of IBEX 35 constituents' the view of Ebrahim (2001). The sample of the study was collected from IBEX 35 index (Spain). It had collected a sample size of 42 companies for period between 1997 and 2004. The study attempted to explore the role of auditors in prevention of the creative accounting practice. As the result, this study had supported the significant role of auditors in financial market particularly in the prevention of CA practice.

Clikeman (2003) mentioned in his journal of 'Auditors on Alert for Earnings Management' that the external auditors are not only the staff who detect the CA practice but the internal auditors also have a duty and role in prevention such a practice and to comply with various requirements of the standards and Acts, such as Auditing standards and Sarbanes-Oxley Acts. The internal auditors have many measurements available to assist them in detection unethical practices. the trend analysis to find out extraordinary variations in revenues and expenses and cutoff testing which enables to monitoring sales and purchases in income statements of the company for the year's end. These are some of the tools available for the auditors to detect any suspicious occurred and reported to the board.

Director should be the one who should detect fraud at the first place as he is in position that allows him to access to every single part of the business. Thus, the government and the regulatory should have to improve the rules of the board of directors and management teams rather than focusing only on the auditor's responsibility. Although there are many regulations for the auditors to conduct their work efficiency, there were many corporate

scandals cases recently. This indicates that there are still some weaknesses in these standard and regulations.

The implication of CA on the country's economy

Everyone is concerning about CA including analyst, regularities and government due to its impact not only on the firm but also on the country's economy. The previous studies had found that the CA has a negative effect on the economy as a whole especially when it leads to large corporate scandal. One of the recent articles of these affect was by Hugh (2009).

Hugh (2009) explained in his article of ' Creative Accounting and Italy's Growing Unemployment Problem' how the CA affected the Italy economy. He mentioned two types of unemployment benefits that are available in Italy. The Ordinary Redundancy Funds which applies in uncertain event, such as market crises and the Extraordinary Redundancy Fund that available in the case of bankruptcy. To benefit from this scheme, Companies cheating different states by sending their employees home under redundancy procedures and then informally re-employment and paying them under the table. The procedure will allow the firm to pay only 30% of the salary and remain will be paid by the state government. This is lead to the Italian underground economy around 15% of the total GDP for the state i. e. € 300 billion per year. The firms might benefit from the aid but they are distorting the market and discouragement the future of more productive companies.

Others like Bernoth and Wolff (2006) had found in their study of ' Fool the market, Creative Accounting' that the CA increases the risk premium. They used the portfolio model of five interest differential and modified it to

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investigate the implication of CA on bond yield spreads between countries. The modifying process of the model had carried on by assuming that the government might used CA to make the observation of financial position of the country difficult to observe. They found that when the country discloses transparent information, the CA increases the cost of borrowing significantly (if it becomes known) especially in the case when the market is unsure the extent to which the CA exist.

On other hand, Sopelsa (2010) warned in his article of ' US Creative Accounting could repeat Greek Tragedy' that US could face the same problem as Greece heavy debt if it does not control its spending and deal with its structural deficit. This is due to the engagement in CA for years by USA similar to those that occurred in Greece. The US government did not secure the Federal Reserve and government sponsored entities, such as Fannie Mae into its financial statements. As the result, the total debt to GDP had reached to 85 percent and may going to be at 100 percent in two years. Thus, the situation would be worsening if it goes to the foreign loans. The government has to impose tight budget control, alteration social security, deal with health care costs and restructure tax system to generate more revenues.

The CA would lead to economy bubble in country like US as had mentioned by Sopelsa (2010). Instead of blaming the audit firms or the companies that had been got into hot water (involved in scandal), the government should concern first why it is happening. Unfortunately, some governments are aware of what happening neighborhood or far away country but they do not

see the problems in their own countries. They already knew the danger of the CA; therefore they have to find solution to avoid the fraud in the future.

## Chapter 3

### Methodology

This paper is restricted to secondary data that had collected from various source including journals (weekly and quarterly), articles, news paper, magazine, financial reports and so on.

It had reviewed certain literatures which were collected from different sources (as mentioned above).

Later in this chapter, the sampling, data analysis and presentation will be explored.

### Sampling of companies and Data collection

The researcher verified a major accounting scandal that had been occurred last decade, such as ' Enron, Freddie Mac, Halliburton, Merrill Lynch and the recent case of Bernard L. Madoff hedge funds'. These samples were randomly chosen from various cases. Last but not least, among these alleged fraud one sample had been selected which is Enron Corporation.

The financial data of Enron was collected from its annual reports from the year of 1997 to 2000 (see appendix).

### 3. 2 Data analysis and presentation

The Enron Corporation US Energy Company was commenced in 1932. It became as a group of company in 1979. It employed approximately 22, 000 staff in over 40 countries worldwide.

It ranked in Fortune 500 as seventh largest company that operated in American, sixth largest energy Company and one of the leading company in communication, paper and pulp in the world with reported revenue more than \$ 100 billion.

In late 2001, Enron forced to fill up chapter 11 of bankruptcy protection after disclosed fraud and being sued by investors and creditors to claim their privileges. It was one of the largest bankruptcy cases in the US history.

According to Holmes (2006) Kenith Lay (CEO of Enron) used creative accounting as a way to modify reports that allowed them to create artificial shortage by increasing prices about ten times.

In this paper the financial ratios will be used to illustrate the affection of CA on company's annual reports. The ratio will be analyzed for 4 years from 1997 to 2000.

Enron net income should be reduced in 1997, 1998, 1999 and 2000 by \$96 million, \$113 million, \$250 million and \$132 million respectively.

It was also found that companies long-term debts should further added to the one which had reported previously. By the end of the year 1997, the additional debt should be added to give the total of \$14103 million. Similarly, the extra amount of \$ 561 million and \$685 million should be included in 1998 and 1999 respectively to reflect the actual long-term debts of the

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company. The company should also add the amount of \$628 million in 2000 to adjust its debts figure. These balances can be seen as follows:

These were the major items which required adjustments (there were other adjustments which were not taking into account in this study). Next, it will show how the some ratios affected by these adjustments.

Although the gap between the reported amounts is not much different from the adjustment balance, it is significantly important after cumulatively adding these differences for the years. Furthermore, these are information where only available at the time. There are additional adjustments required in balances for some other items, thus the gap will further increase between the reporting and adjustment balance.

It can be found that the major change was in return on share capital which had reached to 2. 6% of the gap between the two balances in 1999 (look to the above table).

The gearing level was high especially in 1997. This indicated that company had too much debt. The debt level decreased significantly in 1999 to 65% after the adjustment that might gave to company a little hope to overcome the problem but its gearing level had increased again approximately to 70% in 2000. This explained why Enron had used CA as it wanted to hide what was going in the company.

### **3. 3 Data presentation**

The below bars chart are an illustration of affection of the CA on the company's balance.



### 3. 4 Finding

It had been founded that after the adjustments in income and long term debts, there were significant changes in returns on capital and in net profit. However, there were other figures that need to be adjusted, thus the affection will be even much greater. Therefore, it led to misguide the public by allowing them to think that the company was in good position and it was a good investment to them but actually it was suffering from heavy debts.

This was one of the companies that used the CA practice. There were other companies that exercise the CA, such as "Duke Energy". As the result, there was a significant negative impact on that industry which in turn had badly affected on US.

The accounting manipulation that had used by Enron affected investors much greater than what had shown above as some bogus figures were not included in this paper.

## Chapter 4

### Conclusion and Recommendation

#### 4. 1 Conclusion

Many corporate accounting scandal cases had occurred since 1980. One of the earliest scandals was an Australian "Nugan Hand" Banks and the latest case of "Lehman Brothers" and "Golden Sachs". Yet, there will be many

accounting scandals may the world face if nobody try to improve the procedures to prevent the CA.

The paper had discussed various issues regarding to creative accounting. It had explained why the company's directors involve in CA to commit fraud. The most common reason is the one that mentioned by Dharan and Lev (1993) and it said; when the company wants to increase its share price.

The paper had explained some of the techniques of CA which can be used by the firms including changes in accounting treatment, adjustments in provision of bad debts, movements of the figures between the accounting period and many more.

It had also discussed about the responsibility of the auditors, especially external auditors, in corporate scandal and how to detect the potential fraud. In addition, it had also explained the role of the auditors in minimizing the risk of CA by disciplinary following the audit standards and some other regulations. The quality of auditors is also play important role in detection the fraud.

Finally, the literature review warned the affection of CA on the economy. It had found that in some cases the CA increased the rate of interest and it would lead to heavy debt burden to country that exercising CA as what happened in US. Moreover, it would affect the GDP as in case of Italy.

In methodology, it had talked about the sampling and from where the data was collected. Then, it had analyzed annual report of Enron Corporation form the year 1997 to the year 2000. It had found the earnings of the company

that reported were difference from the one after adjustment. As the result, it had given a bogus report to the stockholders.

#### 4. 2 Recommendation

Many issues had occurred because of the CA, some had already mentioned in this paper and remain were discussed by the others. Some are blaming the auditors whereas others are saying it is the government responsibility. However, there are many people are involved in the CA. To overcome the problems of this practice, the researcher had given various suggestions from different point of view which can be seen below.

From the investors' point of view, they can follow certain steps to reduce the risk of CA. The investors should not depend only on company's financial statements in deciding of whether it is worthy for their investments. They should also seek for second professional opinion because sometimes the F. S accomplished with material misstatement.

The investors should diversify their investments widely and not to keep them in one basket. Although it is difficult to eliminate risk, the investors can reduce such it through spreading their security into wide range of companies or even investing in other countries so if there is any loss in one company resulting from the practice, they will gain in another one. Therefore, the investors can make profit from their average returns regardless of some negative investment that included in portfolio.

From the companies' point of view, they should appoint more independent directors to take care of public interest, thus avoiding personnel interest.

This would lead to the more honest in reporting of the company situation. In case if there is a tragedy event, they will solve it in prudent way rather than using unwelcome practices.

They should also appoint qualified audit committee with high level of experience and honesty to detect the material misstatement that could occur in the F. S. Moreover, the audit committee will take all the necessary steps to prevent such fraud.

Whereas from the government's point of view, it should select appropriate standards and follow excruciating punishment against those who breach the rules. In addition, although there are some countries not allowing the auditor firm to provide more than one service, there are some governments allow the firm to provide various services to its client. This should be avoided in each country.

Chapter 5